MERISTEM

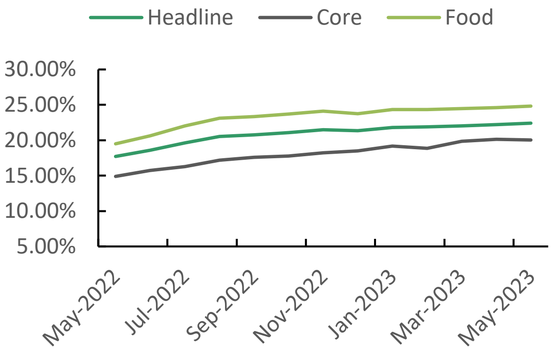
Macroeconomic Update

Inflation Report for May 2023

Key Summary Statistics

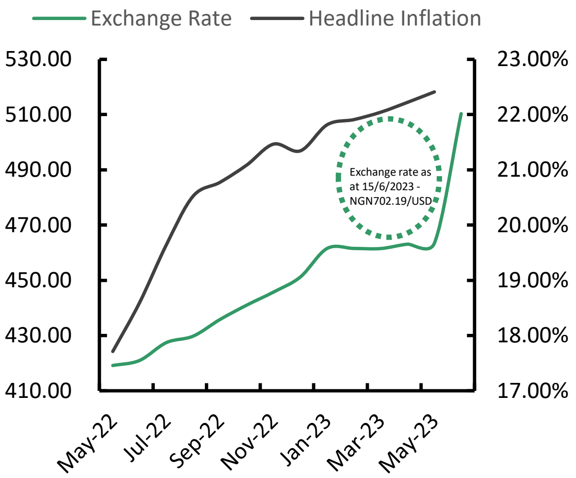
Category	May-2023	Apr-2023	May-2022
Headline inflation	22.41%	22.22%	17.71
Food inflation	24.82%	24.61%	19.50%
Core inflation	20.06%	20.14%	14.90%
Imported Food inflation	18.72%	18.65%	17.75%

Chart 1: Trend in Headline, Food, and Core Inflation



Source: NBS, Meristem Research

Chart 2: Movement in Exchange Rate NGN/USD and Headline Inflation



Source: NBS, FMDQ, Meristem Research

Shy of our projection of 22.42% by 1bps, the National Bureau of Statistics (NBS) reported that headline inflation for May 2023 came in at 22.41% YoY (vs. 22.22% YoY in April 2023). The uptick in inflation was primarily driven by the increase in the food index as it rose by 24.82% YoY (vs 24.61% YoY in April) due to higher prices of food items like oils & fat, yam & tubers, bread, cereals, fish, potatoes, fruits, vegetables, and meat. In contrast, the core index grew at a slower pace by 20.06% YoY from 20.14% YoY in April due to the base effect from the corresponding period last year. On a month-on-month basis, inflation remains elevated as the headline, core, and food index grew by 1.94% MoM, 1.81% MoM, and 2.19% MoM (vs 1.91% MoM, 1.46% MoM, and 2.13% MoM in April 2023), respectively. Consequently, the real rate of return remains negative despite consistent efforts by the monetary authority to curb rising inflation.

Food inflation Continues to Erode Sticky Disposable Income

Domestic food prices maintained an uptrend owing to the widening gap between the demand and supply of food items in the country. Output in food-producing regions remains depressed as challenges like insecurity, and insufficient investment in the agricultural space, adverse weather conditions continue to negatively impact food production/harvest. Furthermore, we opine that the increase in export duty of palm oil in April 2023 by one of the largest producers (Indonesia) gave rise to an increased cost in palm oil prices in May 2023.

In the near term, we project a sustained rise in the food index hinged on the expectation of higher transportation and farming cost. In our view, the currency devaluation poses a minimal risk to the food index given that the parallel market which already had higher rates is a major source for a number of importers.

Base Effect Relieves Core Inflation

The core index recorded its second disinflation of the year owing to the moderating effects of the significantly higher rates recorded in May 2022. We also do not rule out the positive impact of lower gas prices in the period. The World Bank Pink Sheet reveals that natural gas price has maintained a southward trajectory since December 2022 and as of May 2023, the index has declined by 66.39% YoY (83.63pts vs 248.79pts in May 2022). However, on a month-on-month basis, the core inflation rate edged higher by 0.35% MoM largely driven by the higher cost of transportation by air and road, fuels, and vehicle spare parts, amongst others. Furthermore, we observe that the transport sub-index (+23.87% YoY) recorded its highest spike since July 2007 (+27.40% YoY) during the month. In our view, reported cases of fuel scarcity during the month and the unofficial repricing of PMS prices which initially followed the President's inaugural speech were the major culprits responsible for the uptick.

Going forward, we note that the deregulation of Premium Motor Spirit (PMS) and the operational changes in the foreign exchange market pose material upside risks to inflation.

Will the Devalued Naira Impact Headline Inflation?

In line with our expectations intervention at the official exchange rate window was effectively lifted during the week and has resulted in a significant devaluation of the FX rate (USD702.19 vs USD 472.50 as of June 9th, 2023). While this is a welcome development – *as it allows the currency to reflect market realities* –, it is expected to have an impact on price stability and consumer purchasing power.

On one hand, the currency devaluation poses minimal risk to the food index, considering that most importers source foreign exchange from the parallel market (which already has higher exchange rates). However, more impact will be felt from the surge in energy prices. Recall that the NNPC (which is the official importer of the refined product) previously had access to import the commodity at the managed rate.

We expect that the proposed exchange rate convergence should lead to a higher supply of the greenback and improve its liquidity. This improved liquidity should also act as an attraction point for foreign capital into the country who have had capital repatriation as a major concern for investing in Nigerian assets. While this is a step in the right direction towards the unification of exchange rates, proper management, and policy reforms to ensure actual unification must come in tow. The devaluation alone is not likely to be sufficient in achieving the actual unification of rates if the FX supply remains low and existing backlogs are not cleared. We also expect an initial overshoot in the parallel market above the current NGN760/USD before the rates eventually settle. **We have reviewed our end-of-year forecast of the USD/NGN exchange rate to reflect these expectations. Particularly, our expectation is for the NGN/USD to trade within a band of NGN724.41/USD to NGN765.31/USD.**

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